

Government of the District of Columbia
Department of Insurance and Securities Regulation



Lawrence H. Mirel
Commissioner

April 3, 2002

Council of the District of Columbia
Chairman Linda W. Cropp
1350 Pennsylvania Avenue, NW
Washington, DC 20004

Re: Proposed Conversion and Merger of CareFirst, Inc.

Dear Chairman Cropp:

Thank you for your letter dated March 13, 2002 requesting information about the proposed conversion of CareFirst, Inc. from a nonprofit hospital and medical services corporation to a for-profit health insurer, and its subsequent acquisition by WellPoint Health Networks Inc. ("WellPoint"), a California-based for-profit health insurance company. Prior to answering your questions, it may be helpful to provide you with some background information that I believe will be helpful to your understanding of the transaction, and describe the efforts that have taken place to date.

Introduction

CareFirst, Inc. is currently a Maryland-based nonprofit hospital and medical services corporation that is the holding company of Group Hospitalization and Medical Services, Inc., the District of Columbia's Blue Cross Blue Shield plan ("GHMSI"), CareFirst of Maryland, Inc., Maryland's Blue Cross Blue Shield Plan, and Blue Cross and Blue Shield of Delaware, Inc., Delaware's Blue Cross Blue Shield plan.

GHMSI, a federally chartered nonprofit corporation, is domiciled in the District of Columbia and is regulated by the Department of Insurance and Securities Regulation ("DISR"). GHMSI provides health insurance to insureds in the District of Columbia, Northern Virginia north of route 123, and Prince George's and Montgomery Counties, Maryland, offering indemnity, health maintenance organization products, and administrative only services.

On January 11, 2002, WellPoint filed a draft application with the DISR for permission to convert the nonprofit GHMSI to a for-profit stock corporation and to allow the acquisition of GHMSI. Rather than acquiring GHMSI directly, WellPoint proposes to acquire the CareFirst holding company, which includes GHMSI as well as the Maryland and Delaware Blue Cross Blue Shield plans, and would operate the three plans on a for-profit basis. Blue Cross Blue

Shield of California is the predecessor to WellPoint, which has acquired and operated other Blue Cross Blue Shield plans throughout the United States, including Missouri and Georgia.

In order for the proposed acquisition to go forward, WellPoint and CareFirst need the approval of the insurance regulators of the District of Columbia, Maryland and Delaware, of both the proposal to convert to for-profit status and the sale of CareFirst to WellPoint. The insurance commissioners of each of the three jurisdictions plan to retain experts from various disciplines, including legal, investment banking, accounting, health care, and actuarial, and will hold public hearings prior to making a decision to approve or disapprove the proposed transaction.

Assuming the insurance commissioners approve the transaction, the Office of the Corporation Counsel (the "OCC") and the Attorneys General in the other jurisdictions are required to ensure that the proceeds offered by WellPoint for CareFirst's assets are adequate, and that they are used to continue the charitable mission of the Blue Cross Blue Shield companies. The OCC is responsible for creating a charitable foundation, and the OCC will need to retain experts from various disciplines including legal, investment banking, and financial to fulfill its statutory obligation. The DISR will retain its own experts to, among other things, advise the Department on the impact the proposed transaction will have on the health insurance market in the District. Finally, the OCC and DISR intend to hire an investment banker to represent both agencies, and will work cooperatively throughout the review of the proposed transaction in an effort to reach a decision that is in the best interests of GHMSI's policyholders and District residents at large.

Responses to Questions

Q1. What criteria will you use in determining whether the proposed conversion/merger is in the public interest? What process and method of investigation will you follow in determining whether the conversion/merger is in the public interest? Does CareFirst have the burden to prove that the proposed conversion/merger is in the public interest? Will you be enlisting the services of independent experts to help you assess whether the conversion/merger is in the public interest? Will recent Council action affect your ability to retain these experts? If so, what subjects will such experts be asked to address? Will the applicants be required to pay for such experts or reimburse their expenses?

A1. The Form A Application submitted by WellPoint for the conversion and acquisition of GHMSI will be reviewed to determine if it satisfies the statutory requirements set forth in section 16(b) of the Hospital and Medical Services Corporation Regulatory Act of 1996, D.C. Official Code § 31-3515 (b), and section 4(g) of the Holding Company System Act of 1993, D.C. Official Code § 31-703(g). Beyond the statutory provisions, the specific criteria to be used to determine if the proposed transaction is in the public interest will be developed by the experts from various disciplines that will be retained to assist in the review of the proposed transaction. The OCC will review the transaction to determine if it satisfies section 4(c) of the Health Care Entity Conversion Act of 1997, D.C. Official Code § 44-603(c).

The Hospital and Medical Services Corporation Regulatory Act and the Holding Company System Act require the Mayor to approve the transaction unless the Mayor

finds that the proposed transaction is inequitable to policyholders or the public. Accordingly, CareFirst is not required to prove that the proposed transaction is in the best interests of its policyholders or the public. The Department intends to retain, at WellPoint's expense, independent experts from various disciplines to assist in the review of the proposed transaction. Those disciplines include legal, investment banking, financial, actuarial, executive compensation, and healthcare experts. The OCC intends to retain legal counsel and investment banking experts to assist it in its review of the valuation issues, including the division of any charitable assets that may arise in the event the proposed conversion and acquisition is approved. The DISR and OCC intend to share the services of one investment banking firm.

The Council's recent adoption of the emergency resolution will enable the Department to retain independent experts without the necessity of having to go through the prolonged RFP process, which we were told would take three to four months. As you are aware, the Maryland Insurance Commissioner, Steve Larsen, has already begun public forums and hearings. The Department sought an exemption from the District's procurement laws because it is imperative that we be able to retain our experts in the next few weeks and begin the review process, so that the District can protect its interests by being a participant in the review process sooner rather than later.

Generally, the independent experts will be asked to determine if (1) the proposed transaction will be harmful to GHMSI's policyholders and the District's insurance buying public; (2) the proposed transaction will adversely effect GHMSI's capital and surplus; (3) if any of GHMSI's assets will inure to private persons; (4) if there are any plans to liquidate, merge or make any material change to the GHMSI's business or corporate structure, and (5) those persons that would control GHMSI are competent, experienced and have integrity. The DISR will select the independent experts, and all of the fees and expenses of those experts will be paid by WellPoint directly to the experts. No District funds will be spent on experts. Moreover, the agreements between WellPoint and the independent experts will contain language making it clear that the District will not be liable for payment in the event that a dispute arises regarding the payment for services rendered.

Q2. How will you determine the effects of a conversion/merger on the number and classes or groups of the insured? Will you determine who will be insured and who will lose coverage should a conversion/merger be approved, and in what other ways coverage of those currently insured will be affected? For example, will you determine whether the conversion/merger may cause any increase in premiums or decrease in benefits? (I understand that quite recently the insurance commissioner in Kansas disapproved a proposed conversion of that state's Blue Cross based on a determination that the conversion would cause an increase in premiums.)

A2. We will examine the specifics of the proposed transaction here in the District and neighboring jurisdictions, as well as WellPoint's acquisitions in California, Missouri, and

Georgia to determine what effect, if any, the proposed transaction will have on the products and services currently being offered to individuals, small groups, large groups, and those in the federal employee program. Our insurance and actuarial experts will examine the proposed transaction and advise us about the potential for any increases in the number of uninsured persons in the District, including whether WellPoint would have to increase health insurance premiums or reduce services as a result of the acquisition. We are aware of the Kansas order, and have met with the Kansas Insurance Commissioner's staff to discuss their findings. While we will certainly learn from the experiences of the Kansas Insurance Department's review of the proposed conversion and acquisition of its Blue Cross Blue Shield company, that transaction is not germane to the proposed transaction in the District because it involved a different for-profit health insurer—Anthem Insurance Companies, Inc. Moreover, the District's Administrative Procedure Act requires me to treat this matter as a "contested case" and I must be careful not to base my decision on anything other than relevant issues that are made part of the record as a result of the administrative hearings I plan to hold in the coming months.

- Q3. *The application and accompanying documents indicate that CareFirst and WellPoint have agreed upon \$1.3 billion as a "sale price." Will the Department determine whether this \$1.3 billion in fact constitutes the full and fair value of CareFirst? Will CareFirst have the burden to show that the agreed price in fact constitutes the company's full and fair value? What methodologies will the Department use to determine that the offered price constitutes full and fair value? Will the Department engage an independent expert to help it determine the company's full and fair value? Will WellPoint be required to pay for any such expert? Will expert assistance also be sought in determining: whether CareFirst needs to convert in order to remain a viable, competitive insurer; whether CareFirst exercised due diligence in determining to sell itself to WellPoint for the agreed \$1.3 billion; and whether the terms of the proposed conversion/merger are in the public interest (including CareFirst's agreement to pay WellPoint \$37 million if a better offer is accepted from another purchaser)?*
- A3. Most of the "valuation" issues in the proposed transaction will be addressed by the Office of the Corporation, which will review the transaction to ensure that it satisfies section 4(c) of the Health Care Entity Conversion Act of 1997, D.C. Official Code § 44-603(c). We have been advised that the first step in determining an appropriate price for CareFirst's assets will be to examine the due diligence performed by the board of directors of the operating companies because they have a fiduciary duty to ensure that the citizens of each jurisdiction receive the appropriate value for the companies. If we determine that the GHMSI board failed in its responsibilities in this regard, it is possible that we may require CareFirst to "re-bid" the companies to determine if another company would be willing to pay more for CareFirst's assets. Assuming it is not necessary to re-bid the companies, our investment banking experts will likely use several methods of determining GHMSI's assets—including a discounted cash flow analysis, the amount of tax relief it received since its inception, the book value of the company's assets, the fair market value of the company's assets, and other factors. In addition the \$37 million "break up" fee may become an issue if it is determined that the boards failed to fulfill its fiduciary responsibilities in accepting a \$1.3 billion purchase price, and it becomes

necessary for CareFirst to solicit additional offers from other health insurers. The fee, however, is not *per se* invalid or unenforceable, but should instead be reasonably related to the expenses incurred by WellPoint as a result of its due diligence in making an offer for CareFirst. We intend rely heavily on our legal and investment banking experts to assist of with this aspect of the transaction. WellPoint will bear the burden of all costs associated with these and other experts.

Blue Cross Blue Shield plans have cited various reasons for their need to convert from nonprofit to for-profit health insurers, and we will certainly examine the reasons carefully. The statutes governing this transaction, however, do not require CareFirst to demonstrate that it must convert to remain a viable, competitive insurer. In other words, CareFirst has presented us with its plan to convert and to be acquired, and the Department must approve the plan unless there is evidence, which is made part of the record that would establish that the conversion will be harmful to GHMSI's policyholders or the insurance buying public. The law, as it currently stands in the District, does not require CareFirst to demonstrate that it must convert and be acquired in order to survive in order for us to approve the transaction.

Q4. How will the District's share of the value of the company be determined in the event the proposed conversion/merger is approved?

A4. The first step in determining the share of the value of the company that will go to a District-based foundation will be determine the value of GHMSI. The independent investment banking firm that we retain will assist us in the valuation. As part of that valuation, we will also determine how much of the value of GHMSI is attributable to its operations in northern Virginia and Prince George's and Montgomery Counties, Maryland, and how much of the value can be attributable to its operations in the District. This valuation process is likely to result in a range of values rather than a single number. Consequently, there may be some negotiations among the jurisdictions to determine the appropriate way of measuring GHMSI's assets, and how they should be divided. However, it is very unlikely that a District-based foundation will receive one hundred percent of the value assigned to GHMSI because the attorneys general in Maryland and Virginia will claim for their respective states a portion of GHMSI's charitable assets.

Q5. How will the responsibilities for reviewing the proposed conversion/merger be divided between your office and the Office of the Corporation Counsel?

A5. The Department will review the transaction to determine if it satisfies the requirements of D.C. Official Code §§ 31-703 and 31-3515. The OCC will review the transaction to determine if it satisfies the requirements of D.C. Official Code § 44-603. The DISR and OCC will divide our responsibilities based on our respective statutory obligations, and will work cooperatively in an effort minimize a duplication of efforts.

6. *Will the Department consider the extent to which CareFirst has been carrying out its not-for-profit charitable and benevolent purposes as required by its federal charter, bylaws, certificate, and local law? Is it within your authority to require CareFirst to carry out*

those purposes where it is not in compliance? As a related question, what is the correct baseline for measuring the likely impact of the proposed conversion/merger: will you compare CareFirst's recent market conduct with changes that are likely to occur after the conversion/merger; or will you, instead, compare the likely changes with CareFirst's conduct had it more closely adhered to its federal charter and charitable mission?

- A6. The Department will review the proposed transaction to ensure that it is not inequitable to GHMSI's contractholders or the insurance buying public, and will include an examination of its federal charter, by-laws, certificate of authority, and local law and regulations. The Department has full authority to require GHMSI to comply should we determine it is not in compliance with its certificate of authority or District law or regulations. It is beyond the authority of the DISR to take any action with respect to its federal charter or the by-laws adopted pursuant thereto, which would require an act of Congress. First, we have no evidence that GHMSI has violated its federal charter, by-laws, certificate of authority, or any law or regulation. However, if we receive such evidence during the course of our examination, we will certainly investigate it, and take the appropriate action. Second, we intend to examine the proposed conversion and acquisition very closely to ensure that it will not, among other things, be inequitable to GHMSI's contractholders or the insurance buying public by examining what impact, if any, the proposed transaction will have on GHMSI's contractholders and the District's health insurance market if the transaction is approved.
7. *What steps will the Department take to ensure that no officer or director of CareFirst is being enriched by or has a conflict of interest concerning the proposed conversion/merger?*
- A7. We will review all executive compensation contracts, board minutes, and other relevant documents to ensure that no officer or director is improperly enriched or has a conflict of interest concerning the proposed conversion and acquisition.
8. *What role will the public and various public interest and consumer health groups play in your review of the proposed conversion/merger? Will they be invited to participate in the regulatory process? Will they have the right to present evidence and testimony and to conduct cross-examination?*
- A8. The Department has been in contact with various public interest and consumer health groups to inform them of the status of our review of the transaction, and we will continue to keep them informed as we proceed. It is our objective to have an open process, and all interested persons and organizations with varying viewpoints will be invited to share their views at public forums we intend to hold in late May and early June of this year. Those same organizations will be invited to attend and participate in the official hearing of this matter, which is tentatively scheduled for some time in November of this year. The Department is currently developing Preliminary and Case Management orders that will describe the rights of those persons and organizations that will be allowed to participate in the hearing and to what extent. The orders will include a category of participants that will be allowed to present evidence, testimony and conduct discovery, and present direct

and cross-examination. A second category of participants will be allowed to present oral or written testimony that will become part of the official record, but will not be allowed to conduct discovery, or present direct or cross-examination.

9. *With respect to DC statutory and regulatory provisions, are they adequate to meet the anticipated challenges of the application and regulatory process? Does your department have the necessary or preferred legislative and regulatory “tools” with which to discharge the complete vetting and decision-making tasks you will encounter? Should the DC Council review specific provisions or applicability of the current legislative and regulatory schemes?*
- A9. The DISR believes the District’s statutory and regulatory provisions are adequate to fulfill its statutory obligations in the review of the pending transaction. There is language concerning the ownership of a converting entity’s assets in D.C. Official Code § 31-3515(a), which states that “For the purpose of such conversion, the owners of the corporation shall be contractholders and surplus note holders, if there are any surplus notes.”. This language is inconsistent with the provisions in D.C. Official Code §§ 44-603(c)(12) and 44-604 that require the charitable assets of the converting nonprofit entity to be placed in a charitable trust controlled independently of the for-profit entity or other parties to the conversion.
10. *Do you encourage or contemplate communication, formal or informal, among the regulators and legislators of the several affected jurisdictions? If you encourage such communication, to what purpose and within what time frame should it occur?*
- A10. I have been in communication with the insurance regulators from Maryland, Delaware and Virginia on both an informal and formal basis. I plan to continue to communicate with them to the extent I may do so consistent with my role as the final decision maker regarding the pending conversion and acquisition. My staff and outside counsel will continue to communicate with the aforementioned regulators concerning issues that would be inappropriate for me to address. I have not been in contact with any legislators from other jurisdictions, and presently do not have any intention to make such contacts. I will instead rely on my fellow regulators to keep me, our outside counsel, and my staff informed of legislative developments.
11. *Are there lessons to be gained from conversions and mergers sought and/or achieved elsewhere in the nation? Are there exemplars having specific instructional value for the District and the other CareFirst jurisdictions? Which are they and why do you find them particularly instructive?*
- A11. DISR has reviewed the Blue Cross Blue Shield conversions and mergers in other jurisdictions. In fact our legal counsel have participated in some of those transactions. In addition, members of our team, including myself, have met with insurance commissioners from other jurisdictions to get their thoughts on Blue Cross Blue Shield conversions. Each transaction, while instructive for purposes of our review, is unique for numerous reasons, including but not limited to such factors as the amount and type of

consideration offered by the acquiring party, the health insurance needs of the jurisdiction, statutory requirements, political considerations, and other factors. Therefore, we do not find those transactions to have any “specific” instructional value for the matter before the DISR.

12. *The proposed conversion/merger appears to be premised in part on the proposition that the sale price for CareFirst, once transferred to a foundation, will be more than adequate to address any healthcare concerns raised by the transaction. How will you determine whether the District’s share of any sale price is sufficient to address any health concerns presented by the proposed conversion? Have foundations in other jurisdictions successfully addressed health concerns presented by conversions in those jurisdictions?*

A12. At this point, we have not fully developed the record to determine what, if any, healthcare concerns are raised by the transaction. We will, however, carefully explore the impact of the proposed conversion to determine its impact on the District’s health insurance market, and will act to ensure that the proposed transaction is not detrimental to the District’s healthcare market. The District’s current statutory scheme requires the DISR and OCC to ensure that 100% of GHMSI’s value is obtained from WellPoint, and that such value is placed in a charitable trust to be used to further GHMSI’s mission of providing health insurance in the District. We plan to hire an investment banking firm to review the process that CareFirst undertook in agreeing to a purchase price of \$1.3 billion. We will also ask the investment banker to conduct a separate valuation of GHMSI to ensure that the sales price is adequate. We cannot say at this point whether the foundations in other jurisdictions have successfully addressed the healthcare concerns of those jurisdictions. Our examination of the conversions in other jurisdictions will include a review of the foundations to determine their experiences.

I appreciate the opportunity to address your questions, and look forward to working with you and the Council as we move through this process.

Sincerely,

Lawrence H. Mirel
Commissioner

